

Summer 6-1-1988

State Takeover Statutes: Constitutionality, Community, and Heresy

Lyman P. Q. Johnson

Washington and Lee University School of Law, johnsonlp@wlu.edu

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Banking and Finance Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Lyman P. Q. Johnson, *State Takeover Statutes: Constitutionality, Community, and Heresy*, 45 Wash. & Lee L. Rev. 1051 (1988), <https://scholarlycommons.law.wlu.edu/wlulr/vol45/iss3/7>

This Comment is brought to you for free and open access by the Washington and Lee Law Review at Washington & Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington & Lee University School of Law Scholarly Commons. For more information, please contact lawref@wlu.edu.

COMMENTARY

STATE TAKEOVER STATUTES: CONSTITUTIONALITY, COMMUNITY, AND HERESY

LYMAN JOHNSON*

The student writers of the following Note¹ have asked me to address the topic of state takeover legislation. I do so both to extend the constitutional debate concerning takeover statutes to a third form of takeover statute that the Note does not discuss—the business combination statute—and to place the entire subject into a somewhat larger perspective. My comments are brief.

In 1982 the United States Supreme Court struck down the Illinois Business Take-Over Act in *Edgar v. MITE Corp.*² Ironically, that decision was probably the best thing that ever happened to state takeover statutes. It caused a fundamental rethinking of the basis for state intervention in takeover battles and led to a radical shift in the legislative program of takeover opponents; a program apparently vindicated in 1987 when the Supreme Court upheld Indiana's Control Share Acquisitions Act.³

In reaction to the *MITE* decision states adopted a brilliant strategy: place takeover laws into general corporate statutes. This approach to takeover regulation had two advantages. First, lodging takeover laws in a larger body of law that states unquestionably were authorized to formulate—the body of law governing corporate “internal affairs”—was perceived to immunize them from constitutional attack. Second, existing corporate statutes already were decidedly pro-management and, thus, takeover laws could be fitted into a pre-existing regulatory regime without need for more overt state action of the kind overturned in *MITE*.

As made clear by the following student Note, there is little question after *CTS Corp. v. Dynamics Corp. of America* that two relatively mild sorts of second-generation takeover statutes are above constitutional reproach: the control share acquisition statutes and the fair price statutes.⁴ More intriguing is the constitutional status of a far more potent form of legislation, the “business combination” statute pioneered by New York.⁵ This kind of statute has been adopted, with variations, by several other

* Assistant Professor of Law, Washington and Lee School of Law. B.A. 1973, Carleton College; J.D. 1978, University of Minnesota.

1. See Note, “*May We Have the Last Dance?*” *States Take Aim at Corporate Raiders and Crash the Predator's Ball*, 45 WASH. & LEE L. REV. 1059 (1988).

2. *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

3. *CTS Corp. v. Dynamics Corp. of America*, 107 S. Ct. 1637 (1987).

4. Of course, those statutes that apply to foreign corporations remain suspect.

5. N.Y. BUS. CORP. LAW § 912 (McKinney 1986).

states, most notably Delaware.⁶ As with control share and fair price legislation, business combination statutes follow the "corporate law" approach to takeover regulation. Also, as with fair price legislation, such statutes do not directly regulate the tender offer process as such. Rather, they operate post-takeover by prohibiting a successful bidder from causing the acquired target company to engage in statutorily-defined "business combinations" for several years unless target management assents. While in form operating only after a takeover has succeeded, the obvious purpose of these statutes, as with all antitakeover legislation, is to deter takeovers in the first instance. They do so by discouraging would-be bidders from pursuing companies whose assets cannot be drawn on to pay off the staggering acquisition indebtedness incurred to accomplish many of today's takeover transactions. In short, the hope is that the post-acquisition moratorium will, *ex ante*, create a substantial disincentive to the initial launching of takeover bids.

Obviously, one important question is whether such a statute is constitutional under the reasoning of *CTS*. As to preemption by the Williams Act, Justice Powell's opinion in *CTS* fudged an important point that is central to resolving the constitutional status of business combination statutes: Does the Williams Act mandate that shareholders possess the critical decisionmaking authority on takeover issues? A plurality of Justices in *MITE* believed that state bureaucrats may not hold such authority, while the Court in *CTS* held that shareholders as a group may possess that power. But what about target management itself? May states assign the pivotal decisionmaking role in takeovers to those very persons the bidder is seeking to displace?

In subscribing to the oft-cited but little-explained "policy of neutrality,"⁷ a plurality in *MITE* adopted what might be called a "shareholder autonomy" reading of the Williams Act — *i.e.*, that under the Williams Act individual shareholders ought to decide basic stock disposition questions. In short, attention is focused on the *process* by which takeover contests are resolved. In *CTS* Justice Powell expressly refrained from adopting or rejecting that reading of the Williams Act. Instead, he evaluated the Indiana statute by gauging how it fulfilled what might be called the larger, more substantive "investor protection" goals of the Williams Act. Once a takeover bid had been launched the Indiana statute appeared to address the problem of coercion inherent in partial and two-tiered tender offers—two exceedingly rare species of bid today—and also empowered shareholders *as a group* (although not individually). Consequently, the Court concluded that the statute was consistent with investor well-being. Missing from Powell's analysis was any discussion of whether such protection for shareholders actually receiving a takeover bid had been achieved at too high a price. That is whether, *ex ante*, shareholders as a class might be damaged by the statute because it reduces the aggregate level of takeover activity by creating too great a disincentive for bidders.

6. DEL. CODE ANN. tit. 8, § 203 (1988).

7. For a detailed critique of the current controversy over Williams Act preemption, see Johnson and Millon, *Misreading The Williams Act* (forthcoming).

Because Delaware's corporate jurisprudence—both statutory and common-law—long has entrusted corporate management, as fiduciaries, to “protect” the interests of investors, it is logical that Delaware's takeover statute similarly would entrust not bureaucrats or fellow shareholders but management itself to “protect” investor interests in takeovers. Must that cardinal tenet of state corporate law yield to avoid preemption by the *MITE* plurality's “shareholder autonomy” reading of the Williams Act, or can Delaware's paternalistic approach to investor protection be fitted into Justice Powell's end-oriented and more substantive notion of “investor protection?”

In three 1988 decisions the Federal District Court of Delaware, after much hand-wringing, upheld the Delaware statute against constitutional challenge.⁸ The court emphasized the apparent substantive advantages of management involvement for investor well-being and, somewhat at odds therewith, the “meaningful” ability of shareholders themselves to resolve takeover contests notwithstanding management opposition. In essence, the Court read the Williams Act as requiring at least enough shareholder say in takeovers to overcome a management veto. To that extent, the Act is viewed as adopting, or at least assuming the existence of, a *process* component.

At about the same time, a Wisconsin federal judge, in a decision later withdrawn when the case was settled, struck down the Wisconsin business combination statute on the process-oriented “shareholder autonomy” rationale of the *MITE* plurality.⁹ He believed that management involvement in the takeover decisionmaking process of the kind provided for in the Wisconsin business combination statute was formidable and therefore antithetical to the Williams Act conception of investor protection. Accordingly, the Wisconsin statute was preempted. This issue undoubtedly will be revisited in other states and, because it goes to the very heart of the question of how states may use their corporate statutes to allocate decisionmaking power in corporate takeovers, it is likely to require resolution by the Supreme Court.

While the constitutionality of state takeover legislation is of obvious importance, it is, in a sense, only a threshold issue. Suppose that the business combination statute, and even more robust forms of takeover legislation as undoubtedly will follow in its wake, are constitutional. Then the question—a far more interesting question—is whether those statutes will succeed in accomplishing their objectives. What exactly are those objectives?

Even though some commentators still defend state takeover statutes on shareholder protection grounds,¹⁰ by now that ruse is largely over. The

8. *BNS, Inc. v. Koppers Co.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) 93,730 (D. Del. April 1, 1988); *R. P. Acquisition Corp. v. Staley Continental, Inc.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,763 (D. Del. May 9, 1988); *City Capital Assocs. v. Intercor*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 94,079 (D. Del. Sept. 23, 1988).

9. *RTE Corp. v. Mark IV Indus.*, Unpublished Memorandum Decision and Order, No. 88-C-378 (E.D. Wis. 1988).

10. See, e.g., Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635

statutes are not primarily aimed at enhancing the wealth or governance position of nonresident shareholders, but at preserving intact the corporate ecosystem of resident companies. From both a political and an economic standpoint, it makes a great deal of sense for states to prefer the interests of those various noninvestor constituents who vote and directly contribute to their economies over those persons — *i.e.*, nonresident shareholders—who have a much weaker connection to the state. As I have argued elsewhere,¹¹ I believe current state efforts will fail to accomplish their primary objectives. Accordingly, simply passing constitutional muster is of little significance if the larger efficacy of the legislative enterprise is in doubt. Still, in spite of their probable failure, state efforts to deploy their corporate statutes to protect noninvestor interests warrant serious reflection for two reasons.

First, state takeover statutes are an attempt by states to assert some influence over the manner in which the inanimate “market for corporate control” plays itself out on the lives of their citizens. These attempts often are dismissed out of hand as “quaint,” “misguided,” or “smacking of parochialism.” At the limit, even genuine good faith efforts to attain a greater measure of economic self-sufficiency must also be so labeled. In other words, frankly to disdain the gravity and speed of change wrought on local economies by highly-developed, almost frenetic capital markets is not only a sure precursor to proposing supposedly unconstitutional burdens on interstate commerce, but also to be extraordinarily unenlightened. The progeny of Sinclair Lewis’ *Carol Kennicott* and *George Babbit* must awaken and divine the path of Progress. They must flee the suffocating air of the hinterlands and be “redeployed” in more invigorating climes.

If indeed local and regional economies are to be rescued from the miasma of place and continually “disciplined” by the rigors of the national and international capital markets, one wonders with Wendell Berry whether authentic community is still possible—authentic in the sense of being more than what we call people who live in close proximity to one another.¹² Can there be genuine community in the sense of a place that is central to its own inhabitants’ well-being without also having local, even somewhat self-sufficient economic endeavor? If true community depends on economic health, then a relentless buffeting of local economies may do little for communal well-being. It would be ironic if, in trumpeting the virtues of unchecked market solutions, those persons who politically distrust centralized political power and favor its dispersion serve to undercut the economic roots of geopolitical diversity and viability.¹³ It is odd that the antidote for

(1988) For a response, see Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. ____ (forthcoming 1989).

11. Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. CORP. L. 35 (1988).

12. W. BERRY, *Does Community Have a Value?*, in HOME ECONOMICS 179 (1987).

13. For a discussion of how a desire to control political power through decentralization

excessive or misguided public political power is private economic power that itself alters the political and cultural fabric in ways that only accelerate the call for public intervention of the kind evidenced by state takeover laws.

Traditionally, conservatism has meant more than a strong preference for the private sector as a counterpoise to the public sphere. It also has been keenly protective of institutions such as family, church, and local communities as vibrant sources of energy and influence. Today, the latter component of conservatism seems threatened by a preference for the private sphere and the imperative of economics. A vision of diversity and pluralism, even a measure of insularity, gives way to one of transcendent interconnectedness and convergence. If not a world polity or community, some seem to say, then why not, at least a world market-place? In response to this, is it illicit for a community to turn a bit inward, and to establish its own good as the standard by which it changes rather than responding solely to "forces, originating outside itself, that did not consider, much less desire, the welfare or the existence of such communities[?]"¹⁴

Conversely, as economic forces erase state and national borders, what continued purpose is served by political boundaries and the even more ineffable social boundaries of locale? Do we substitute for the traditional, deep-seated claims of place and all that entails some hard-to-muster allegiance to an authoritative abstraction called the national or world economy? Is the notion of "national community" itself somewhat of a distortion, and a recent one at that, as Professor Nisbet suggests; an intellectual fiction necessary for legitimizing the world-shrinking developments in technology and commerce?¹⁵ Of necessity, when economic forces so quickly can traverse political and cultural boundaries, old-fashioned "off the books" virtues such as neighborliness, charity, rootedness, and abiding loyalty are forced to yield to more measurable, supposedly neutral and uncontroversial qualities encapsulated by the principle of "efficiency." Perhaps the appeal of a notion like efficiency is its very "thinness," its happy ability to mask how differently people from varying places and backgrounds view the world. Whether that is for the good, or even possible to resist, seems a question worth lingering over from more perspectives than the economist's. For now, the universal rhetoric of markets seeks to silence other vernaculars.

The second reason to reflect on state efforts to protect noninvestor interests is that in addition to saying something about what the populace at large expects of corporate endeavor, state takeover statutes also are a real burden for corporate scholars. Up until the 1960's corporate law was plagued by a deeply-embedded problem. It presumed that in a capitalist society corporate endeavor primarily was directed toward maximizing the

of economic power motivated the Sherman Act of 1890, see Millon, *The Sherman Act and the Balance of Power*, 61 S. CAL. L. REV. 1219 (1988).

14. Berry, *supra* note 11, at 183-84.

15. See Nisbet, *The Present Age and the State of Community*, CHRONICLES, June, 1988, at 11.

welfare of capital-providing shareholders, and that other important societal interests were more or less congruent with that objective. Corporate statutes were designed along the lines of a democratic polity in which shareholder-constituents elected their director-representatives. The common law also regarded directors as fiduciaries for the "corporation and its shareholders," insisting, at least in theory, that management channel its awesome power toward achieving the good of others—the shareholders.

Notwithstanding the premises and design of the corporate law regime, many reluctantly believed that in fact management held the upper hand, and that the legal edifice was a bit of a hoax. Into this dilemma came hostile takeovers and the larger market-oriented view of corporations that we now know so well. This phenomenon breathed fresh life into corporate law, producing an entirely new conception of the director-shareholder relationship and mending the embarrassing rift between theory and practice. If legal "rules" could not effectively constrain management discretion and preserve shareholder primacy, then various markets could; including, most notably, capital markets and the market for corporate control.

Dereliction by corporate management would be reflected in a corporation's stock price and would afford an opportunity for profit to someone who believed that he could put corporate resources to better use. The passageway to corporate assets is the capital markets where, for a premium, a controlling stock interest can be acquired. Thus, in one fell swoop the tenets of economic and legal orthodoxy are preserved and shareholders are returned to a central place on the corporate stage. Shareholders fortunate enough to own stock in target companies are enriched directly, while other shareholders realize gain from the renewed vigilance that the threat of takeover draws from corporate managers. And too, society at large benefits or, more properly, its interest in an "efficient" use of economic resources supposedly is served. Social welfare is equated with that which can be measured.¹⁶

States that "corrupt" their corporate statutes by consciously deploying them to deter market forces such as hostile takeovers for the good of local communities and resident noninvestors upset this tidy scheme, and such actions are, in a word, heretical. After all, some would say, corporate law is and always has been only about the shareholder-management relationship and it fastidiously has eschewed other concerns.¹⁷

One response then is to drive such concerns—typified by a modern takeover statute—from corporate law, restoring it to its former state of conceptual purity. One significant incident of this vision of corporate law is to embrace, at least implicitly, the larger social and political repercussions

16. For one critique of the limitations of the contractual and market-centered model of corporate law, see Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 CALIF. L. REV. 1015 (1988).

17. For a description of corporate law in an earlier day, see Millon, *State Takeover Laws: A Rebirth of Corporation Law*, 45 WASH. & LEE L. REV. 903 (1988); Johnson, *supra* note 10, at 27-29.

felt in local communities as capital market forces drive corporate action. Another response is not to worry about such laws because state efforts will fail anyway, and are best forgotten as an unfortunate aberration. A third response is to ask whether twentieth century corporate law has been too narrowly conceived; whether because there are certain phenomena of which it gives no good account it consciously chooses to ignore them and focus on "maximization of shareholder welfare" as its sole and authoritative marker.

Perhaps the narrowed realm of concern is quite sensible and bespeaks a commendable modesty of ambition. On the other hand, maybe its rendition of corporate activity is simply incomplete, a point flushed out by the takeover controversy. The pages of intellectual history are filled with instances of discarded world views—one thinks of Newtonian mechanics and pre-Darwinian biology; those temporary orderings of physical and social phenomena that were displaced by richer, more inclusive (but also imperfect) paradigms.

State takeover statutes thus raise the question of whether the entire corporate industry—the laws that shape and regulate it, those who govern business entities, and those who counsel participants and affected parties—ought to operate wholly within such a narrow and rigid conception of corporate endeavor with its elevation of events on unfettered capital markets as the content-less touchstone of collective enterprise. Or alternatively, whether some actors are entitled to say "no" and begin, however poorly at first, to rechart a different course. These questions might usefully be taken up by larger segments of communities, and be grappled with by persons from outside the now highly-rarified mode of discourse on corporate matters. These questions go well beyond the issue of constitutionality.

